

DoD Fast Track Guidance

This paper contains DoD's official guidance on what types of relationships between a small company and outside investors in the company qualify as an investment under the SBIR and STTR Fast Track ("Fast Track investment"). It includes specific examples of company-investor relationships that we have been asked about and our official responses on whether these relationships qualify as a Fast Track investment. If you have questions about whether a particular company-investor relationship qualifies, please contact the DoD SBIR/STTR Help Desk (tel. 866/216-4095, e-mail sbirhelpdesk@pbcinc.com). The Help Desk will refer any policy or substantive questions to appropriate DoD personnel for an official response.

I. General Guidance on What Qualifies As A "Fast Track Investment"

- The investor must be an **outside** investor, which may include such entities as another company, a venture capital firm, an individual "angel" investor, a non-SBIR/non-STTR government program, or any combination of the above. It does not include the owners of the small business, their family members, and/or "affiliates" of the small business, as defined in Title 13 of the *Code of Federal Regulations* (C.F.R.), Section 121.103. As discussed in that Section:
 - ▶ Concerns are affiliates of each other when one concern controls or has the power to control the other, or a third party or parties controls or has the power to control both.
 - ▶ [We] consider factors such as ownership, management, previous relationships with or ties to another concern, and contractual relationships, in determining whether affiliation exists.
 - ▶ Individuals or firms that have identical or substantially identical business or economic interests, such as family members, persons with common investments, or firms that are economically dependent through contractual or other relationships, may be treated as one party with such interests aggregated.
 Although DoD is guided by this definition of affiliation in the Code of Federal Regulations, we also exercise our own discretion whether a particular entity qualifies as an "outside investor".
- The **investment** must be an arrangement in which the outside party provides cash to the small company in return for such items as: equity; a share of royalties; rights in the technology; a percentage of profit; an advance purchase order for products resulting from the technology; or any combination of the above.

II. Specific examples of What Does and Does Not Qualify As a "Fast Track Investment"

A. Examples of What Qualifies as an "Outside" Investor

(1) Can a small company contribute its own internal funds to qualify for the Fast Track?

No. DoD is seeking outside validation of the commercial potential of the company's technology, and therefore requires that the funds come from an outside investor. Also, cash from an outside investor shows up plainly on the company's books and therefore can be more readily verified than a company's own matching contribution.

(2) Company A spins off company B, which wins a phase I SBIR award. Company A then wants to contribute matching funds to qualify company B for the Fast Track. Can A be considered an outside investor for purposes of the Fast Track?

In making our determination of whether company A is an outside investor, we would be guided by the definition of "affiliates" in 13 C.F.R. Sec. 121.103, discussed above. Our presumption is that in this example A and B would be considered "affiliates," and that A would therefore not be an outside investor for purposes of the Fast Track. However, that presumption could be rebutted by showing, for example, that the spin-off occurred several years ago and that A and B do not exercise control over one another, do not have common ownership or management, have different business interests, etc.

(3) Small company S wins a phase I SBIR award. The president of S is a major shareholder in another company Y, which wants to contribute matching funds to qualify S for the Fast Track. Can Y be considered an outside investor?

Our presumption is that Y would not be considered an outside investor. Our determination would be guided by whether the president's stake in Y is large enough that S and Y would be considered "affiliates" under 13 C.F.R. Sec. 121.103. Subsection c of Section 121.103 specifically discusses affiliation based on stock ownership:

c. Affiliation based on stock ownership.

1. A person is an affiliate of a concern if the person owns or controls, or has the power to control 50 percent or more of its voting stock, or a block of stock which affords control because it is large compared to other outstanding blocks of stock.
2. If two or more persons each owns, controls or has the power to control less than 50 percent of the voting stock of a concern, with minority holdings that are equal or approximately equal in size, but the aggregate of these minority holdings is large as compared with any other stock holding, each such person is presumed to be an affiliate of the concern.

If S and Y are found to be affiliates, we would determine that Y is not an outside investor.

(4) Does the outside investor have to be a single entity (e.g., a single venture capital firm) or can it be more than one entity (e.g., two angel investors and a venture capital firm)?

It can be more than one entity.

(5) Small company A contributes matching funds to small company B in order to qualify B for the Fast Track, and, at the same time, B contributes matching funds to A in order to qualify A for the Fast Track. Do A and B qualify as outside investors under the Fast Track?

No. A and B's relationship is such that their investment in each other would not provide outside validation of the commercial potential of their respective SBIR projects. We would therefore not consider them to be outside investors for purposes of the Fast Track.

(6) Can the brother of an employee of small company S contribute funds to qualify S for the Fast Track?

Probably not. Again, we would be guided by the definition of "affiliates" in 13 C.F.R. Sec. 121.103. The brother presumptively would be an affiliate of company S and not an outside investor.

(7) Venture capital firm V currently is a 22 percent shareholder in small company S. Can V invest additional funds in S to qualify S for the Fast Track?

Our presumption is yes. In making our determination, we would be guided by whether V and S are "affiliates," as defined in 13 C.F.R. Sec. 121.103. Section 121.103 provides (in subsection (b)(5)) that a venture capital firm is not affiliated with a company if the venture capital firm does not control the company -- e.g., by owning more than 50 percent of the stock of a small company (prior to its investment under the Fast Track), as described in 13 C.F.R. 107.865. 13 C.F.R. 107.865 can be viewed on the internet at <http://www.acq.osd.mil/sadbu/sbir/affil2.htm>.

(8) Large company L makes a cash investment in small company S, and then serves as a subcontractor to S on an SBIR project. Can L's investment in S count as a matching contribution for purposes of the Fast Track?

Only L's cash investment net of its subcontracting effort can count as matching funds for purposes of the Fast Track. For example, if L invests \$750,000 in S and subcontracts with S for \$250,000, only L's net contribution (\$500,000) can count as matching funds for purposes of the Fast Track.

(9) Company Y makes a cash investment in small company S for purposes of the Fast Track, and also enters into a separate contract with S under which Y provides certain goods/services to S in return for \$500,000. Can Y's cash investment in S count as a matching contribution for purposes of the Fast Track?

As in the previous example, only Y's cash investment net of the \$500,000 it receives from S can count as matching funds for purposes of the Fast Track. However, if the separate contract between Y and S pre-dates S's submission of its phase I SBIR proposal, Y's entire cash investment can count as matching funds for purposes of the Fast Track.

(10) A group of investors wishes to invest funds in small company S to qualify S for the Fast Track. One of the investors is the mother of S's president, who wants to contribute \$50,000 toward the effort. Can the group's investment in S count as a matching contribution to qualify S for the Fast Track?

The mother's investment of \$50,000 does not count, because she is not an outside investor (see item (6) above). Contributions of the other investors can count provided that they meet the other conditions for the Fast Track (e.g., each must be an outside investor).

B. Examples of What Qualifies as an "Investment"

(1) Can a loan from an outside party qualify as an "investment" for purposes of the Fast Track?

No. The rationale behind the Fast Track is that an outside party is betting on the company's success in bringing the technology to market -- not just its ability to repay a loan.

(2) How about a loan that is convertible to equity?

A loan that is convertible to equity at the company's discretion would count as an investment under the following circumstances: (1) the loan is provided by a public entity (e.g., a state agency), or (2) the loan is provided by a private entity, and the SBIR company actually converts the loan to equity before the end of phase I.

(3) Can in-kind contributions from an outside investor count as matching funds under the Fast Track?

No. The matching contribution must be in cash. A cash contribution is a stronger signal of the outside investor's interest in the technology, and can be readily verified.

(4) Can a purchase order from an outside investor count as a matching contribution under the Fast Track?

An advance purchase order for new products resulting from the SBIR project can count as a matching contribution under the Fast Track (assuming the other Fast Track conditions are met).

(5) Can the funds raised from an initial public offering (IPO) count as matching funds for purposes of the Fast Track?

Yes, as long as the offering memo indicates that a portion of the funds from the IPO will pay for work (e.g., R&D, marketing, etc.) that is related to the SBIR project.

(6) If large company L pays small company S for work related to S's SBIR project and expects a deliverable (goods or services) from S in return, would that qualify as an "investment"?

No, for the same reason a loan does not count. Specifically, in this situation the large company is not betting on the small company's success in bringing the technology to market, but merely on its ability to provide the deliverable.

C. Examples Re: Timing/Logistics of the Fast Track Investment***(1) Can entity E's investment in small company S during the first month of S's phase I SBIR project count as a matching contribution to qualify S for the Fast Track?***

Yes, provided that E is an outside investor and that the other Fast Track conditions are met. The investment can occur any time after the start of the phase I project.

(2) Small company A, which has won a phase I award, spins off small company B to commercialize the SBIR technology. A then convinces angel investor I to invest funds in B. Can I's investment in B count as a matching contribution to qualify A for the Fast Track?

For I's investment in B to qualify A for the Fast Track, DoD must determine that A and B are substantially the same entity, as evidenced, for example, by their meeting the definition of "affiliates" in 13 C.F.R. Sec.121.103. If DoD determines that A and B are substantially the same entity, I's investment in B could qualify A for the Fast Track. Of course, the parties must also meet the other conditions for the Fast Track (e.g., I must be an outside investor).

(3) Small company S is collaborating with a university on an STTR project. Investor I wishes to provide funds to the university in order to qualify S for the STTR Fast Track. Can I's investment in the university count as a matching contribution to qualify S for the Fast Track?

In order to qualify S for the STTR Fast Track, I's investment of funds must be in small company S, not in the university. S can then subcontract some of the funds to the university. The rationale is that a cash investment in the small company is a very strong indication of commercial potential, whereas an investment in the university is less so.